

# ***THE RICHBÄCHER LETTER***

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The year fast falling into history opened with economists confidently predicting that the good times were ready to roll and Wall Street soothsayers forecasting finis to the bear market. As the year ends, we are still waiting, too, for the bear market to lumber out of town...The bad news, we might interject here, is that on the eve of the new year the economists, although a tad more timidly, once again are voicing optimism, and the Street sages, those who are still employed, anyway, are as full bull as ever.

Alan Abelson, "What Goes Around," *Barron's*, Dec. 30, 2002

## **THE COMING DOLLAR CRASH**

Entering the New Year, the dollar's fate is definitely the single most important question for the world economy and world investors. It is really the greatest wild card in the world economic outlook. After a very slow start, the dollar's decline has been gaining momentum. But where will it end? Could last year's dollar retreat turn into a dollar crash, possibly with disastrous implications for the U.S. financial markets if not for the whole financial system? These are the questions that we explore in this letter.

On Dec. 31, 2002, the euro traded against the dollar at \$1.05, up from \$.8915 at year-end 2001, reflecting a gain of 17.8%. Compared to its earlier peak of less than \$86, the U.S. currency has lost altogether 22%. For European investors, these currency losses are adding hugely to their heavy losses on U.S. stocks. Actually, the dollar has lost what it had gained over the prior three years. In other words, its fall is considerably steeper than its rise.

When a surplus country stops investing its surplus in full into dollar assets, its currency will increase against the dollar. As the exports of many countries have become addicted to the U.S. consumer's spending excesses, their governments are desperate to prevent such a rise of their currency, hurting the competitiveness of their export industries. Once more, dollar reserves of foreign central banks are ballooning at record rates. Europe, that is, the European Central Bank, is the one great exception to general, foreign government support of the dollar.

The single biggest buyer and supporter of the dollar is China's central bank. There are calls from many corners of the world that China ought to allow its currency to float upward, and other countries would probably feel comfortable to follow suit.

No such calls are coming from the United States, though it would help its manufacturers. This silence has an obvious reason. A general floating of currencies would implicitly mean the end of the dollar standard, and that would badly hurt America's financial system by ending the capital inflows from central banks.

## **SPOTTING A BUBBLE ECONOMY**

For years our assessment of the U.S. economy's intrinsic health and strength has been in diametric contradiction to the euphoric consensus who proclaimed and hailed a new paradigm economy purveying unprecedented productivity and profit miracles. For us, the strikingly obvious reality in America was the worst bubble economy in history. Our vehement dissent had two main sources: strict reliance on macroeconomic growth theory and careful, critical scrutiny of monetary and economic statistics.

Many times over the years we have expressed our horror about Alan Greenspan as the chief culprit behind this insanity. But he alone could not have done it. It also needed an army of insane bankers, corporate managers and investors who blindly swallowed the whole new paradigm nonsense about the U.S. economy.

According to Mr. Greenspan, asset bubbles are not recognizable before they burst. We have always vehemently disputed this assertion. In any case, that's not the crux of it all. What crucially matters is not the asset bubble as such, but the effects that it exerts on the economy's overall structure as businesses or consumers use

the inflating asset values for unsustainable borrowing and spending binges. These resulting maladjustments are, in essence, the decisive economic damage that occurs, and they are in general highly visible and easy to identify.

In Japan's case of the late 1980s, the bubble-related spending excess went mainly into business fixed investment and commercial building. In the U.S. case, the spending excess, fueled by the share-price bubble, went overwhelmingly into consumer spending, showing spectacularly in collapsing personal saving, in the soaring share of consumption in GDP and in the exploding trade deficit.

Another very important and also spectacular clue was, of course, the developing virtual money and credit explosion. As to the trumpeted productivity and profit miracles, we have been stressing and substantiating for years that these alleged and celebrated miracles rested on deceptive figures.

Mr. Greenspan keeps defending himself with the argument that a central bank should exclusively focus on the inflation rate as the crucial emblem of economic balance. In this view, a low inflation rate apparently entitles a central bank to allow totally uncontrolled money and credit creation.

Plainly, there must be some limit to credit growth regardless of the inflation rate. It used to be commonplace in economics, in fact, that credit growth, for whatever purpose, should never exceed available savings. It is the function of credit to transfer the financial and real resources that the savers release to the borrowers who will use them by their spending. Any credit growth in excess of the savings limit ranks, by definition, as credit inflation.

In the United States, credit exploded while national saving collapsed. Most obviously, the unusually low long-term interest rates have nothing to do with purchases from a high rate of saving. It is common knowledge that they are artificially depressed by boundless financial leveraging accommodated by the Fed through unfettered monetary looseness.

### **THE U.S. ECONOMY'S TRUE SOURCE OF GROWTH**

According to the prevailing general image and perception, the U.S. economy's stellar growth performance during the past several years derived mainly from three features: *first*, an enormous lead in the new information technology; *second*, its new entrepreneurial culture guided by the imperative to maximize shareholder value; and *third*, unparalleled labor market flexibility.

All these years, it was our contention that the effects of these influences were grossly misjudged. At the height of the stock market boom, we extensively expounded in two monthly letters — under the titles “Orwell Newspeak and Doublethink” (December 1999) and “‘New’ or ‘Late’ Capitalism?” (January 2000) — that in diametric contradiction to the frenzied propaganda about a profit miracle, the U.S. economy's actual profit performance, measured by national income data, was the worst in all postwar cycles.

We also explained in these letters in detail, not for the first time, that the new information technology along with the merger and acquisition mania were, from a macro perspective, in reality crucial in depressing corporate profits in the United States. Verbatim: *"Recognizing the crucial role of capital accumulation as the major macroeconomic corporate profit source leads to our conclusion that the new information technology as well as the new corporate preferences for cost-cutting, restructuring, downsizing, mergers and acquisitions implicitly tend to reduce aggregate profits."*

***Crucial to our extremely negative view about the U.S. economy's performance is the distinction between capital gains through rising asset prices and capital accumulation through saving and investment in the real economy. In the past years America has had far too much of the former and far too little of the latter. What's more, these capital gains overwhelmingly fueled consumption at the expense of domestic investment and the trade balance.***

Again verbatim from the January 2000 letter:

*Frankly, it stuns us how easy it is to fool the whole world for so long a time about the dismal realities of the Anglo-American capitalism and the U.S. new paradigm economy. We guess the overabundance of information offered by the new technology makes it ever more difficult for many*

*people to distinguish between the wood and the trees. No less baffling is the general, virtually blind belief in Wall Street's pretentious claim that the shareholder value imperative has done miracles to Corporate America and the U.S. economy and that policymakers and corporate managers around the world are consequently to be judged by the degree of their acquiescence in American-style cost-cutting and deal-making capitalism.*

*What counts under this capitalism is not what happens in the factories but what happens to shareholder value. What matters most under its reign is the efficiency of corporate management in selling restructuring stories and future profit miracles with immediate effects on shareholder value. It has really become more show business than capitalism...*

Our utter disbelief in the economic miracles accruing from the new information high tech started with the simple recognition that it represents far too small a share of GDP to make such a tremendous splash. In hindsight, the years 1997–2001 have been the U.S. economy's main bubble years. In 1997, spending on hardware of the new information technology amounted to \$208.7 billion and to \$223.9 billion in 2001, after a peak of \$267.5 billion in 2000. That was little more than 2% of GDP.

In other words, business investment on new high-tech hardware increased during these boom years by the ridiculous amount of \$15.2 billion, and bear in mind, these are gross figures that include sharply rising depreciation charges. Pondering these numbers, one realizes that the hype about the wonders of the new information technology was sheer absurdity. Spending on computers, by the way, ran at \$79.6 billion in 1997 and at \$74.2 billion in 2001, after \$93.3 billion in 2000. For sure, this was not a meaningful source of economic growth.

But then what else was the effective main source of the boom of the late 1990s? That, too, was manifestly evident in the statistics right from the beginning for anybody who cared for the truth. The most spectacular and most extraordinary feature of the U.S. economy at the time was the most rampant money and credit creation in history for consumption, speculation and corporate financial manipulation.

The essential benchmark for comparison is nominal GDP growth. From 1997 to 2001, it amounted \$1,763.8 billion. Over the same period, the money and credit aggregates grew as follows: the money supply M1 +\$107.1 billion; M2 +\$1,427.5 billion; M3 +\$2,582.3 billion; nonfinancial, non-federal debt +\$4,558.5 billion; financial debt +\$3,946.7 billion.

Together, the increase of the credit and debt aggregates added up to \$8,505.2 billion. In terms of these numbers, Mr. Greenspan was the most successful Fed chairman. But the relationship between credit growth and GDP growth was by far the worst in history. It took 4.8 dollars of new debt to create one dollar of incremental GDP. And never forget that every single dollar added to credit is a dollar added to somebody's indebtedness.

## **MORE OF THE SAME IMBALANCES**

It is widely emphasized and hailed that the U.S. economy has proven highly resilient to the bursting of the bubble, as a shallow recession in 2001 was followed by a year of 3% real GDP growth. But what was the source of this widely hailed resilience?

Within two years, the Federal Reserve cut its short-term interest rates by 525 basis points. There was a credit expansion of more than \$3,000 billion. The Federal budget balance has swung from a 2% surplus (as a share of GDP) in 2000 to a 2% deficit in late 2002. Finally, there has been the dollar's depreciation. And what was the effect of this most aggressive and massive stimulus in history? It was jobless and profitless GDP growth of about \$700 billion altogether over two years, being followed now by a new recession. Up till quite recently, we have been reading glowing reports about how well the U.S. economy has been coping with the aftermath of the bubble. Further, sustained and accelerating economic growth in 2003 and 2004 has long since been a foregone conclusion for the consensus.

It was in particular the upward revision of U.S. real GDP growth in the fourth quarter of 2001 from 0.2% to 1.4% that abruptly rekindled the old euphoria about the U.S. economy's performance, triggering immediate growth forecasts between 4–5% for 2002. Under the title "Bogus Recovery," our April 2002 letter vehemently

objected to this view. Therein, we explained in detail that the "grossly imbalanced pattern of GDP growth in the fourth quarter" flatly disqualified it as the possible start of a sustainable recovery.

The ill-structured growth pattern of the fourth quarter of 2001 — higher consumer and government spending versus falling investment spending — has since prevailed. Recessions reflect the correction of the imbalances that have accumulated during the prior boom. The U.S. economy's weak performance during the past two years effectively reflected more of the same old imbalances, only with less economic growth. Thanks to the housing bubble, the consumer was able to keep up his borrowing and spending excess. That made the recovery.

As to the protracted slump in business fixed investment, a widespread, comforting interpretation says that businesses are positively correcting their past investment excesses. But such excesses never existed. U.S. economic growth during the past few years was lopsided as never before toward consumption, and that implicitly curtailed the share of GDP available for capital spending. Growth of net fixed investment has been at a historic low. Its chronic weakness is the U.S. economy's central structural problem.

### **PROTRACTED PROFIT WOES**

Sharply rising business investment on equipment has typically led all postwar cyclical recoveries. On average, American postwar recessions lasted a little less than one year. It is now fully two years since the U.S. economy went into recession. For the first time ever, business fixed investment has continued to decline, though lately at a slower pace. Oddly, it completely failed to take part in the recovery that ended in the third quarter of 2002. In actual fact, this was decisive in aborting the recovery.

Manifestly, there was no lack of cheap money and credit that could have strangled the recovery. While today's persistent investment drought is generally explained with lacking demand and existing idle capacities, its obvious, original cause was the profit carnage that started in 1997 at the height of the U.S. economy's boom. This profit carnage and its underlying causes have been a main theme in these letters.

While there may be short-term fluctuations in profits, we remain pessimistic about their trend. This pessimism begins with the general consideration that Corporate America's recent profit performance has been dismal for quite a few years, among them several boom years. If profits fall even under such favorable economic conditions, it is difficult to envisage rising profits under present most unfavorable conditions.

Above all, though, we see no letup in the main causes of the profit squeeze, including the misguided bias in corporate strategies toward mergers, acquisitions and cost-cutting. From a micro perspective, they seemed to promise easy and quick profits. But from a macro perspective, all this created no economic value. Instead it misled numerous corporations to a neglect of organic growth through new investment in plant and equipment, destroying economic value and profitability. The other big, structural destroyer of corporate profits is the huge trade deficit, implying a massive diversion of spending towards foreign producers.

What's more, a big, new threat to profits is inexorably piling up in corporate balance sheets from escalating pension woes. For many years, rising funding obligations have been abundantly met by the big capital gains that the pension funds gathered from the booming stock market, to the benefit of corporate profits, of course.

Now the protracted bear market in stocks is hitting corporate profits through the pension funds with a double whammy in reverse. As stock prices plunge and pension liabilities rise, corporations have to accomplish their obligatory contributions, after all, in cash at the expense of their profits. What's more, as the plunging stock prices also deplete pension fund reserves, these have to be replenished as well, also at the expense of profits. Further, major declines in stock prices would spell profit disaster.

From the macro perspective, higher profits would have to come mainly from rising business investment spending or from lower consumer saving. We see neither of the two happening. Investment spending so far shows no sign of life. Personal saving, on the other hand, is increasing as the powerful negative stock market wealth effects outlast the housing bubble.

Only the swelling government deficit is providing limited support to profits.

## **THE U.S. ECONOMY'S CRITICAL JUNCTURE**

Economic downturns are generally caused by monetary tightening, responding to rising inflation rates. Manifestly, this has not been true for the U.S. economy's present slowdown. It happened against the backdrop of runaway money and credit growth and plunging interest rates. Implicitly, this economic downturn had very different causes. The single most striking cause was the profit carnage, acting as a savage depressant on business fixed investment.

But this apparent explanation only raises the next question of what has been ravaging profits. For a capitalist economy, it definitely is the most important question of all. As we have repeatedly expounded, America's profit malaise is nothing new. It really started in the late 1970s. Until then, profits of nonfinancial corporations had fluctuated around 8% of GDP. A steep plunge in the following years slashed it to half that level. From then on, there were only feeble recoveries. In hindsight, the 1980s clearly emerge as the critical juncture in the development of the U.S. postwar economy.

But what explains that sudden, drastic rupture in the profit performance? The fact is that the U.S. economy experienced a variety of changes to its structure in the 1980s that significantly altered its whole growth pattern, of which some were highly detrimental to business profits.

The most striking and hotly disputed novelty in the U.S. economy's new pattern of growth was, of course, the surging trade deficit. It started in 1982 at \$11.4 billion, after a surplus of \$5 billion in the prior year, and it peaked in 1987 at \$167.4 billion, equal to 3.5% of GDP.

Just as striking and also hotly disputed was the equally soaring federal budget deficit. After a steep jump in 1982 to \$161.3 billion, from \$85.5 billion the year before, it peaked in 1985 at \$225.7 billion, equal to 5.3% of GDP.

While the twin deficits almost monopolized the public attention, rather dramatic changes occurred simultaneously in the financial behavior of both the consumer and businesses. Both suddenly discovered the joys of unrestrained borrowing. Over the three postwar decades until 1980, the consumer had run up an overall indebtedness of \$1,404 billion. He boosted that in the following 10 years by 158% to \$3,624 billion. Business debts soared over the same time almost in lockstep by 153% from \$1,474 billion to \$3,735 billion.

The consumer's new borrowing binge essentially had two important macroeconomic effects. In the late 1980s, consumption had accounted for 70% of GDP growth, a record high that compared with a share of 63% in the late 1970s. Its flip side was a decline in his savings rate over the decade from 10% to 7.5% of disposable income. But also given the bursting budget deficit, the net national savings rate — domestic funds and resources available for net new investment — dropped to an unprecedented low of a little over 2%, less than one-third of its historical average of 7.5%.

In the case of corporations, the new proclivity to reckless borrowing went together with a drastic change in the use of the proceeds of borrowing. They borrowed increasingly for financial transactions — including mergers, acquisitions, leveraged buyouts and stock repurchases — and decreasingly for organic growth through investment in new plant and equipment. As net new investment of the nonfinancial corporate sector progressively lagged GDP growth, the economy's capital stock fell sharply as a percent of GDP.

Nonfinancial profits increased between 1981 (a recession year) and 1991 by 37.6%, from \$159.6 billion to \$219.6 billion. Measured as a share of GDP, they declined from 5.1% to 3.7%. It was a profitless expansion.

In hindsight, the U.S. economy in the 1980s already had the key features of a bubble economy, though at a much more modest scale than in the late 1990s. While profit margins fell, stock prices on average more than trebled. The most spectacular maladjustment was the surge of consumption as a share of GDP and its three macroeconomic counterparts: collapsing net national saving, weak net fixed investment and the exploding trade deficit.

## **THE NEW BUBBLE DAMAGE**

Cynically one might say that these changes, indeed, reflected a managerial revolution. They did, of course, but the changes were all of the worst possible kind from the perspective of long-term growth. It has always utterly amazed us how anybody with some knowledge about the essence of economic prosperity could ever have

hailed this pronounced shift in American corporate strategies away from investment in tangible assets towards investment and speculation in financial assets as an expression of superior, new corporate governance.

The economic maladjustments that started in the 1980s went to unbelievable extremes in the late 1990s. Allegations of miraculous productivity and profit effects of the new information technology added immensely to the spreading, frantic perception of a new paradigm American economy. In just 10 years, stock prices more than quadrupled on average.

How, then, did the asset bubble of the 1990s impact the U.S. economy and its financial system? The decisive features to look for are always of four kinds: *first*, changes in the resource allocation between consumption and investment; *second*, profits; *third*, the trade balance; and *fourth*, debt growth.

As earlier mentioned, the economic ill effects of the U.S. asset bubble of the late 1990s closely resembled those of the 1980s in their kind. The great difference is in size. During the 1980s, consumption took up to 70% of GDP growth. In the 1990s, it went to 90% of GDP growth. During the 1980s, the personal saving rate fell from 10.5% to 7.5% of disposable income, in the 1990s from 5% to 1%. Net national saving hit a low of 2% in the late 1980s. Due to the now soaring federal budget deficit, it is heading towards zero and worse. During the 1980s, the U.S. current account deficit peaked at 3.8% of GDP; presently, it is approaching 5% of GDP.

Every asset bubble has been preceded and accompanied by sharply accelerating money and credit expansion. Actually, they rest on nothing else. The reason for that is easy to see: a large part of the money and credit creation in excess of GDP growth flows into the financial markets, forcing up the prices of financial assets; in fact, fueling inflation there.

During 1982–87, total outstanding credit and debt of the nonfinancial sector increased by \$3,889 billion versus GDP growth of \$1,483 billion; during 1996–2001, nonfinancial credit growth of \$4,936 billion compared with GDP growth of \$2,269 billion. An entirely new factor was the exponential rise of borrowing by the financial sector. Its debts grew during the five boom years of the 1980s by \$1,117 billion, but over the five boom years of the 1990s, they soared by \$4,575 billion.

## **CAPITAL CONSUMPTION**

It used to be commonplace in economics that investment in productive plant and equipment is the key to increased productivity and rising living standards. Sufficient investment spending takes care of supply and demand, productivity and profits. But the crucial, negative point to see about the U.S. economy's development is that the key conditions for a high rate of capital spending — saving and profits — have been recklessly ravaged in the past 20 years through policies that boosted consumption and financial leverage at the expense of corporate accumulation of productive capital.

It also used to be commonplace in economics that somebody who persistently spends more for consumption than he earns doesn't get richer but poorer. Implicitly, the same is true for a nation. Yet we keep reading that America has enjoyed its greatest wealth creation of all times in the past several years, vastly outpacing the domestic and foreign debt growth.

How to make sense of that? In short, by distinguishing again between micro and macro perspective. From an individual's viewpoint, rising stock valuations unquestionably add to his wealth. But the crucial point to see is that this wealth adds nothing to the real economy and in particular nothing to its real wealth in the form of productive plant and equipment. From the national perspective, the only way to greater wealth is to construct industrial structures and houses. Strictly speaking, it is net capital investment.

Rising stock valuations rather create claims on the economy. In the United States, they actually fostered the protracted consumer borrowing and spending binges and, as its counterpart, the exponential rise in domestic and foreign indebtedness. For people with common sense, such debt-financed consumption is a clear case of capital consumption or wealth destruction.

## **LIES, DAMNED LIES AND STATISTICS**

In the consensus view, the sharp decline in U.S. business fixed investment is due to prior overinvestment and existing excess capacities. This assessment is based on the fact that America had an unusually high gross investment ratio over the past few years. In our view, the plunge of investment is due to the extraordinary consumer spending excesses that essentially resulted in a drastic shrinkage of the share of GDP that is available for net investment.

What is the difference between the two measures? According to the conventional first gauge, fixed capital investment of firms in the nonfinancial sector accounted for 31% of U.S. real GDP growth between 1997–2000. It was by far America's highest investment ratio in history. According to the second version that we use as a gauge, net investment of firms in that sector accounted for 7.3% of GDP growth in current dollars during this period. Which of the two is the more reasonable calculation?

Net investment is gross investment less depreciation charges. Normally the two move in lockstep, but they diverge sometimes when depreciations slow or accelerate. The latter happened in America in the past few years. As business investment in short-lived computers and software took a rapidly growing share of total investment, depreciation charges have sharply accelerated. A bigger chunk in gross investment is simply replacing capital equipment that wears out, adding nothing to the capital stock and national income. Only investment above the amount lost to depreciation, or net investment, serves to augment the two.

Another major source of the big difference between the two measures of investment derives from the so-called hedonic pricing, in which America's government statisticians value business investment in computers. In 2000, businesses spent altogether \$93.3 billion on new computers, up from \$90.4 billion in the prior year. Measuring in real terms, however, the statisticians come to a vastly higher figure of \$246.4 billion, up from \$207.4 billion in the year before.

By far the single biggest statistical boost to the U.S. economy's investment ratio occurred in 1999. With a stroke of the pen, the statisticians of the Commerce Department took business software spending out of the corporate expense accounts in their GDP statistics and instead capitalized them as investment spending. In one sweep, this drastically padded GDP growth, productivity growth and profit growth. It was, by the way, done retrospectively, and this is included in our numbers.

To give an idea of the impact of this change: In 1997, the prior year, recorded business spending on equipment was \$620.5 billion. In the current statistics, it amounts for the same year to \$764.2 billion. Lately, software has accounted for 45% of total business investment in high-tech equipment. Hedonic computer prices have, on the other hand, been drastically revised downward.

Frankly speaking, it is a statistical muddle. It amazes us how easily the large army of the world's financial and economic experts can be fooled. The miserable reality is that net investment and the capital stock have been sharply falling in relation to GDP since the early 1980s.

## **CAN IT STILL GET WORSE?**

Worldwide, forecasters are virtually united in saying that the string of big losses in the stock markets is bound to stop after three years. It does not bother them that the very same forecast made a year ago went utterly wrong. For sure, a mere lapse of time will not stop this downturn.

What is needed for a sustained recovery of stock prices are measures that correct the imbalances and dislocations that have caused the downturn. We observe no such corrective measures. In essence, Mr. Greenspan's persistent, extreme monetary looseness boils down to the desperate attempt to prolong the excesses of the past. "Inflate, inflate" has been and remains the accepted, compelling mandate of American monetary policy.

Earlier we explained that U.S. economic growth has become geared as never before to unsustainable consumer borrowing and spending binges. That is the one key problem. The other one is the huge, chronic gap in the economy's external current account that has to be plugged by capital inflows. Entranced with the new paradigm euphoria about the U.S. economy, foreign investors and lenders readily obliged. But collapsing profits

and share prices as well as corporate scandals have caused some sobering.

Will last year's dollar retreat turn into this year's dollar crash? That is really the top question for the world economy to ask and investigate because a dollar crash could, and would probably, spill over into the U.S. financial markets, generating upward pressure on interest rates and further downward pressure on stock prices.

*Few people seem to realize that this is the most dangerous economic and financial situation for America since the Great Depression of the 1930s, and accordingly also for the world.*

### **EURO STRENGTH HAS SOLID UNDERPINNINGS**

The obvious reasons for the dollar's decline and the euro's rise are not hard to find: First of all, the former lure of attractive economic and financial conditions and high-riding expectations about future rates of return that have been pulling in foreign capital for years at a more than sufficient scale to finance the huge trade deficit, no longer exist.

A second, though grossly neglected, reason for the stronger euro is a drastic improvement in the euro zone's current account balance. It may have finished last year with a surplus between €50–60 billion, after a deficit of €60.4 billion in 2000 and of €13.8 billion in 2001. It compares, by the way, with a prior drastic deterioration in the current account from a surplus of €62.1 in 1997 to the €60.4 billion deficit in 2000.

The main source of these swings in the current account have been dollar-related changes in the terms of trade, reflecting mainly changes in import prices. Between 1997–2000, when the dollar sharply appreciated, euro zone imports zoomed by 50% in value, more than offsetting the gains in exports. With the dollar's fall, import values are stagnating.

The prevailing perception that Europe had purely export-driven growth in the past few years was therefore grossly misplaced. Rising exports obtained by a falling currency at the cost of sharply deteriorating terms of trade are always a bad bargain. In the same vein, we dispute the view that the falling dollar is harmful for economic growth in the euro zone by depressing exports. Any such detrimental effects on exports are being more than offset by gains in domestic purchasing power through cheaper imports.

On top of the rapidly improving trade balance, the euro zone is also experiencing a drastic improvement in its capital account. For obvious reasons, outflows have drastically declined, while inflows are accelerating. Direct investments outside the euro zone since 2000 have plunged from €344.8 billion to lately around €100 billion at annual rate. Portfolio outflows, both stocks and bonds, plummeted in similar magnitude. Portfolio inflows, on the other hand, are rising, as foreign investors want to profit from the strong currency. On balance, inflows increasingly exceed outflows. Together, all this gives the euro's rise a very solid underpinning.

### **PRECEDENT 1987**

Considering that three years of falling stock prices, a prolonged corporate profit carnage and record-low interest rates, next to Japan, have made America very unattractive for foreign investors, it becomes necessary to ponder the likely speed and magnitude of the dollar's further decline and its potential adverse implications for the U.S. financial markets. We have looked at the dollar's steep rise and fall in the 1980s as an instructive precedent. To begin with, the following charts give an idea of the dollar's enormous swings over three decades.

The dollar actually experienced its steepest rise between 1980–85 from DM 1.72 to DM 3.42. There followed, under great fluctuations, a long slide to DM 1.36 in May 1995. Altogether, this represented a decline over 10 years by 63%. Definitely, this qualified as a "hard landing."

It was the great scare of central bankers that the falling dollar would cause foreign capital to take flight and upset the U.S. financial markets. But even though the dollar went into an almost vertical fall in early 1985, U.S. bonds and stocks continued on their bull run for two years. Yields of 10-year Treasuries slumped from 11.5% in early 1985 to a little over 7% in early 1987. Corporate bond yields took a similar plunge.

But this benign relationship between the skidding dollar and bullish financial markets was to change abruptly in the course of 1987. As the year wore on, the markets became increasingly obsessed with an

escalating trade deficit and the dollar's endless slump.

Bond prices started to plunge right from the year's start. Yet the dollar rebounded, and stock prices continued their bull run. In August the Dow made its high of the year, up 21% since its start.

But sentiment in the financial markets deteriorated dramatically in the year's second half. All of a sudden, attention turned to the trade deficit numbers again showing distinctly deteriorating numbers. It began to be realized that the dollar's steep fall had completely failed to rectify the trade imbalance. Now, stocks, bonds and the dollar slumped in concert.

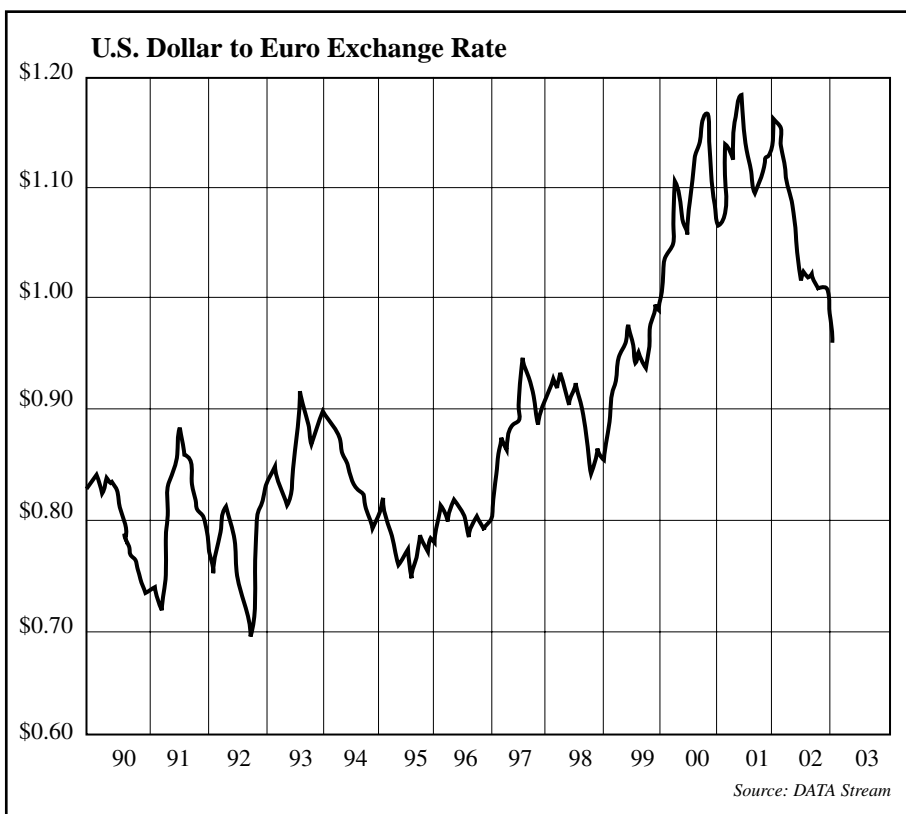
Apparently triggered by unexpectedly bad August trade figures, which the Commerce Department announced on Wednesday, Oct. 14, this development climaxed in mid-October. Within two days, the Dow lost over 250 points, or more than 10%, on a historic high volume — to be followed on the following Monday, Oct. 19, by a virtual meltdown. Within a single day the Dow lost 508 points, or 22.6%.

We have reviewed this episode of 1987 hoping for clues as to the linkage between a steeply falling dollar and the U.S. domestic financial markets. As the strong dollar had strengthened the markets, it appears logical that a falling dollar tends to weaken them. But in 1985–86, both U.S. bonds and stocks remained highly bullish regardless of the dollar's sharp decline, as capital inflows amazingly increased. On the other hand, these flows abruptly dried up in 1987.

### **A BULL RUN WITHOUT BULLS**

Now to the present. Without great ado, the dollar has lost over 25% against the euro. According to widespread opinion, this has less to do with euro strength than with weakness of the dollar, being temporarily hobbled by fears of an American-led war on Iraq. The

euro's bull run, we are tempted to say, has taken place in the virtual absence of euro bulls. Very few people have realized that it is backed by a strong balance of payments.



In view of Europe's dreary economic landscape, there remains overwhelming disbelief in the possibility that the euro may have started a long-term upward movement that still has a long way to go. Its rally is widely expected to end when the U.S. economy sharply recovers after a quickly ending Iraq war.

In our view, this narrow focus on the Iraq war as the mainly disturbing factor for the U.S. economy and its currency is grossly mistaken. In reality, the dollar's protracted fall is driven by serious, adverse economic and financial facts that are as clear as daylight: The U.S. economy is stuck with a variety of unsustainable economic and financial imbalances that are sure to impair economic growth as far as the eye can see.

On the other hand, there seems to remain a general, flat denial that the U.S. economy has very serious economic and financial problems, impairing economic growth for a long time to come. Japan, Germany and most other industrial countries are suffering from the same structural imbalance: insufficient capital investment relative to high rates of saving. But governments and the central banks refuse to use monetary and fiscal palliatives.

Mr. Greenspan, in contrast, has kept the U.S. economy afloat with literally uncontrolled money and credit expansion. With this policy, he created the asset bubble and boosted consumption at the expense of investment and the trade balance. After all, investment exceeds saving. But the reason is devastated saving, not a high rate of investment.

The Greenspan Fed not only refused to put any restraint on the dangerous, out of control excesses, it also acted in words and deeds specifically to maintain and foster the bubble because the alternative — a recession — is not acceptable. Unfortunately, it makes things worse in the long run.

Earlier we said that the greatest wild card is the dollar. It has to be realized that, with the persistent, large deficit in current account, dollar stability is hostage to a very strong American stock market. Attracting the huge amounts of new capital inflows that are needed to finance that deficit would require another stock market bubble. That says it all.

The dollar index topped out a year ago. Starting very hesitantly and gradually, its fall has distinctly gathered momentum in recent months. Considering the resistance of the trade deficit and the worsening economic situation in the United States, it is plainly time to ponder a protracted decline of the dollar and its broader implications.

For obvious reasons capital inflows will continue to fall short of the monstrous current account deficit, and that is all that it needs to depress the dollar. Never forget, the dollar's strength has been borrowed strength.

This development raises two new questions: What can stop the dollar's slide? And what could happen in financial markets if the dollar's slide proves unstoppable?

As to the first question, it is established experience that trade balances respond to changes in the exchange rate with enormous sluggishness, if at all. During 1985–87, the deficit continued to soar, even though the dollar virtually collapsed. In essence, such a deficit reflects an equal excess of domestic spending over domestic output. But currency depreciation, by itself, affects neither of the two. To reduce its trade deficit, the United States would need to lower consumer spending. But that is precisely what the government and Federal Reserve are desperately trying to prevent because it implies recession and rising unemployment.

While sharply slower U.S. economic growth in 2003 may moderately improve the trade deficit, the worsening economic news would frighten foreign investors even more. It is, in actual fact, one of our key assumptions concerning the dollar that an unexpectedly poor performance of the U.S. economy and its stock market in the current year will act as the catalyst that will finally break the illusions about the U.S. economy and the dollar.

## **DOLLAR APOCALYPSE**

While the indulgence of foreigners to invest in the United States is incredible, sharply lower capital inflows are effectively depressing the dollar. With this in mind, it becomes the main question whether its fall could become chaotic, upsetting also the U.S. securities markets, like what happened in 1987.

Up till now, the dollar's decline has been orderly, for an obvious reason. Inertia rules — there remains a fixed, very negative image of the European economy and its currency versus a fixed, very positive image of a dynamic American economy trumping the trade deficit with a superior growth performance. The result is a still-predominating view in the markets that the euro's rally is narrowly limited, while the dollar's next recovery is only a question of time.

Yet this faith in the dollar's impending rebound must be fading. Its decline is ominously gaining speed. The usual explanation is the Iraq war. In the past, though, the dollar used to enjoy safe-haven status. In actual fact, there are plenty of other reasonable explanations for a weak dollar. Most of them are not new. But what is new is the proliferating bad news about the U.S. economy, putting its expected recovery into question. In short, confidence in the U.S. economy's growth prospects is cracking.

Could the dollar's orderly decline turn into a chaotic decline, also capsizing the financial markets? Earlier we described what happened in 1987 when American and foreign investors lost their nerve about the falling dollar. For several months, it spelled disaster also for U.S. stocks and bonds. Yet it proved a brief crash that ended in a soft landing for the dollar and the markets. In so far, it seems a comforting experience.

On closer look, it is not. Today's economic and financial conditions in the United States are incomparably worse than in 1987–89. Economic growth is much slower today, the trade deficit is much higher and interest rates are much lower.

But there is still a fourth factor that makes a great difference: the unprecedented exposure to the risk of a falling dollar, running into trillions of dollars, both from existing foreign holdings of dollar assets and from euro liabilities incurred by American corporations and institutions. The important point here is that both have principally abstained from covering their exchange risk. Strong expectations to gain from a strong dollar or from a weak euro prohibited any hedging.

But the unexpected reality for them now is a falling dollar and a rising euro. Being sure of a further long and steep fall of the dollar, we have been wondering for some time when the foreign investors and American borrowers will finally give up on the strong dollar and stop their bloodletting either by liquidating their positions or by safeguarding themselves at least against currency losses by selling dollars in the forward market. Such hedging has probably started, though at a moderate scale.

This brings us to the destabilizing forces at work in the markets. There is a widespread assumption of a "normal" level of the dollar against other currencies, from which it will not diverge too far or too long. No such level exists. The dollar is effectively out of control. There is no way to say where it may bottom. This is a measure of the macroeconomic costs of allowing an external disequilibrium to become so large and to accumulate for years. The dollar's fate no longer lies in the hands of central banks or banks but in the hands of many millions of fickle private investors.

Mr. Greenspan's extreme monetary looseness created a whole variety of bubbles. The dollar bubble was one of them, and all bubbles infallibly burst. Considering the incredible size of the excesses and imbalances that have accumulated in the U.S. economy and its financial system, there is certainly the potential for an uncontrollable crash of the dollar.

It may be argued that financial markets outside the United States are too small to absorb the large capital outflows from the United States accruing from a flight out of the sinking dollar. The fact is that America's huge deficit in current account allows only capital inflows, even at a large scale, but it allows no capital outflows. It is the huge outflow of dollars through the trade deficit that makes the dollars for capital inflows available. The foreign investors pick them up to buy dollar assets.

Who, however, makes the necessary euros available to those foreign investors who want to exit the dollar for the European currency? Nobody. Given the chronic, national and international U.S. spending excess, there is effectively no way for foreign investors to decrease their dollar holdings in the aggregate. If they attempt to exit, they have to find owners of euros who are willing to switch them against dollars. They will be a rarity in the markets, meaning that the brunt of foreign selling of dollars assets will fall heavily on the currency and the financial markets.

## **PROFITING FROM THE RISING EURO**

What were the most lucrative investments last year? There were just two: euro bonds and gold. Dollar-based investors gained high double-digit profits. Euro-based investors made the smallest gains. Still, they avoided the savage losses that stockholders worldwide have been suffering, and by comparison, that is a great achievement.

Strictly speaking, the key source of the gains is, of course, the sliding dollar, in other words, in the currency play. But the great majority of investors is unfamiliar with the available facilities to exploit currency changes. Over the past several years, ever more sophisticated models have been developed to take advantage of exchange rate fluctuations. We do not believe in mathematics but in economics. The most important question about the world economy is whether or not the U.S. currency has entered a long-term downtrend, as it did in 1973 and 1985.

The latest, popular explanation for the dollar's weakness is the drumbeat of war with Iraq. It may temporarily have accelerated its fall. For us, it is symptomatic for the still-prevailing general refusal to see the serious economic problems in the U.S. economy, depressing economic activity and the dollar in the long run.

For the reasons explained, the fall is mainly against the other major currency, the euro. It is our assumption that over time this will not only lead to hedging against this currency by exporters and holders of dollar assets, but also to escalating speculation.

Hedging means to cover existing risks by buying euros or selling dollars in the forward markets. In Europe, the counterpart of the trade is generally a bank. It can be done for any period, even years. With U.S. interest rates below euro rates, it is even profitable. We presume that widespread disbelief in the possibility of a prolonged bull run of the euro has so far kept hedging against a falling dollar in check.

For the same reason, speculation against the dollar has been slow to develop. But given no other opportunity in the markets to make big profits so easily, we have no doubt that bullish speculation in the euro against the dollar will eventually spread with a vengeance and, in time, precipitate the dollar's slide.

A customary facility, offered by most banks in Europe, is outright dollar sales or euro purchases in the forward market with five time leverage. The speculator, who sells one million dollars to the bank or buys from it one million euros for a later date, has to put up one-fifth of that amount as equity. It even brings a small gain in interest rates, but the speculator bears the full risk. As a rule, the bank requires minimum trades of € or \$200,000–\$300,000.

Another play with limited risk but very high leverage takes place through options. That is, the speculator buys dollar puts or euro calls. As a rule, he buys them at a strike price a bit "out of the money," that is, a little above the market price. Buying, for example, €500,000 for three months at 1% out of the money would have recently cost about \$8,000. During the past few months, it brought multiple gains. But when the market price fails to exceed the contracted strike price within that limit, the premium paid is lost.

The currency play in small amounts largely takes place through the purchase of warrants, sold by a number of banks in Europe, among them Citibank.

### **THE RICHBÄCHER LETTER**

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